IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 722

VICTOR H. AND ELSIE AKIN, FRED C. AND ALICE M. KLUVER, E. F. AND GLADYS MUNROE,

Petitioners,

v.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT.

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January, 1958

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit in the above cause.

OPINIONS BELOW

The opinion of the District Court (R. 96-102), holding that petitioners are entitled to tax refunds, is not officially reported but is unofficially reported at 56-2 USTC ¶9663. The Findings of Fact, Conclusions of Law and Judgment of the District Court (R. 21-25) are not reported. The opinion of the Court of Appeals, which reversed the District Court, is reported at 248 F. (2d) 742.

These are all set forth in the Appendix to this Petition.

JURISDICTION

The judgment of the Court of Appeals, reversing the judgment of the District Court, was entered October 19, 1957. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254. This Petition is filed within the time prescribed by 28 U.S.C. § 2101(c).

QUESTIONS PRESENTED

1. Where farmers customarily must pay annual assessments to a mutual ditch or irrigation company in order to obtain current supplies of water needed for their farming operations, the first question presented is whether the farmers are to be denied "ordinary and necessary" business expense deductions with respect to portions of the annual assessments they pay.

2. The second question presented is whether the Court of Appeals was justified in overturning and disregarding the amply-supported findings made by the District Court, which held that the full amounts of such annual assessments paid by the farmers were ordinary and necessary business expenses.

STATUTE AND RULE INVOLVED

The statute involved in this case is Section 23(a)(1) of the Internal Revenue Code of 1939. The pertinent portion of such section reads as follows:

"Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses—

(1) Trade or Business Expenses—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . . "

The rule involved is Rule 52(a) of the Federal Rules of Civil Procedure, reading in part as follows:

"Rule 52. Findings by the Court.

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon and direct the entry of the appropriate judgment; . . . Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

STATEMENT OF THE CASE

This case involves a very important and very practical matter for farmers.

It is whether the Internal Revenue Service shall be able to prevent farmers from deducting, as ordinary and necessary business expenses, substantial portions of the annual assessments which the farmers must pay to the mutual ditch or irrigation companies to which they belong. These assessments must be paid regularly by the farmers in order to obtain current supplies of the water which is necessary if their farming operations are to be carried on at all.

Petitioners are farmers in Colorado, operating in a region like many other areas in the United States where farming cannot be carried on without irrigation. A principal method by which such farmers obtain water for irrigation is through membership in mutual irrigation companies, which are non-profit tax-exempt organizations.

They acquire this membership by purchasing shares. However, to continue receiving water each year, the farmers must also pay annual assessments.

Petitioners' primary source of irrigation water was the Water Supply and Storage Company and the North Poudre

Irrigation Company. Petitioners, like their parents in earlier years, were members of these two mutual companies; and they were required to pay annual assessments to these two companies in order to obtain water (R. 12, 22, 33, 34, 62, 63). It was essential that the assessments be paid; in the event that petitioners failed to make full payments, the water needed by them would have been cut off (R. 36, 70). Thus, if there is no payment of the assessment, there is no water for the farmer; and if the farmer has no water, he will have no crops.

In 1948, North Poudre assessed its shareholders $12 per share for water;[1] in 1949 the assessment was $11 per share; and in 1950, the assessment was again fixed at $12. The assessments by Water Supply amounted to $220 per share in each of the years 1949 and 1950. Petitioners paid these assessments and deducted the amounts so paid on their 1949 and 1950 income tax returns as ordinary and necessary expenses of their farming operations (R. 13). In taking such deductions these farmers were following the consistent practice they had followed for many years—a practice never questioned by Internal Revenue until the present dispute arose.

In auditing petitioners' 1949 and 1950 income tax returns, revenue agents took the position that a portion of each assessment must be allocated by petitioners to non-deductible capital expense, and therefore must be disallowed as ordinary and necessary business expenses. The reason given by the revenue agents for such partial disallowance was that the companies had expended some of their funds for the purpose of paying off principal on their bonds and because one of the companies had spent money for a right of way (R. 14-18). Petitioners paid the

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[1] North Poudre's annual assessment for 1948 is involved because petitioner Akin paid a portion of that assessment early in 1949.

amounts of additional taxes and interest attributable to such disallowances, and brought this suit for refund in the District Court for the District of Colorado.

The District Court had before it a stipulation of the parties as to certain matters involved in the case (R. 11-20). Both sides made motions for summary judgment (R. 10-11), which the District Court denied on the ground that there were outstanding unresolved questions of fact (R. 20-21). A trial was then held at which witnesses testified extensively and documentary evidence was received (R. 26-96, 102-119). The testimony made it perfectly clear that unless petitioners had paid the annual assessments in full on a current basis, they would have found themselves in the position of farmers who did not have any irrigation water (R. 36, 60).

At the end of the trial the District Court rendered an oral opinion sustaining petitioners' right to a refund (R. 96-102), in which the Court found, among other things, that (R. 101):

> "The testimony is clear that the assessments made against these farmers by the two companies had to be paid or the farmers wouldn't get any water. They couldn't pay part of the assessment and demand the right to water. They had to pay the whole assessment in order to get their water. If they didn't pay it the water was shut off and their stock would be sold to somebody who was willing to pay for it."

The opinion further found that under all the circumstances "these assessments which have to be paid in order for the farmer to receive the water to grow his crops are ordinary and necessary expenses paid or incurred during the taxable year in carrying out the trade or business of farming" (R. 101). Thereafter the District Court made formal find-

ings of fact and conclusions of law and entered judgment holding petitioners entitled to an aggregate tax refund of $4,799.56, including interest (R. 21-25). Among the District Court's findings of fact, based on the evidence, were Findings 15, 16 and 17, which read as follows (R. 23):

> "15. The assessments made by the companies had to be paid in order for the plaintiffs to obtain water. If the assessments had not been paid, plaintiffs' water would have been shut off and their stock could have been sold. In paying the assessments, the plaintiffs' intention in each case was to assure the delivery of water, if available, and not to make a contribution to the capital of the corporations.
>
> "16. The expenditures by the companies out of the monies obtained from the assessments were made merely to assure the continued availability of water divertible under the water rights held by the companies in trust for the stockholders.
>
> "17. The value of the stock of the companies here involved is in the water rights and the expenditure of new money does not add to the yield of the water rights."

The District Court further found that the annual assessments paid by petitioners to the mutual ditch companies were ordinary and necessary business expenses, deductible in full from gross income (R. 24).

The Government appealed (R. 25-26) and the Court of Appeals for the Tenth Circuit reversed. 248 F. 2d 742. The Court of Appeals held that the Internal Revenue Service had correctly allocated portions of these annual assessments, paid by petitioners, to non-deductible capital expense; and that such allocated portions were not ordinary and necessary business expenses of petitioners. The prin-

cipal ground of decision was that "the intended purpose and resulting effect of the payments made by the taxpayers to the ditch companies for use in the retirement pro tanto of the principal together with the accrued interest thereon was to strengthen the financial position of the ditch companies by reducing their long-term obligations," and that "payments of assessments for such purpose fell within the range of capital contributions." 248 F. 2d at 744.

REASONS FOR GRANTING WRIT

This case involves questions of widespread importance to the farmers of this nation. Many thousands of farmers depend for their water supply upon the mutual irrigation companies in their area. These many thousands of farmers have been required to pay annual assessments in order to get their water. Hence they are confronted with exactly the same question which has been put in issue here.

For some of these individual farmers the actual amount of tax money involved may be relatively small. This magnifies, rather than diminishes, the unfortunate results of the present decision, since it increases the possibility that, if the decision is allowed to stand, the Government will obtain a sizeable and unjustified tax windfall at the expense of the farmers and with perhaps a minimal risk of litigation. Looking at the farming industry of this country as a whole, it is plain that the aggregate impact of this decision is serious as well as exceptionally adverse.

The decision of the Court of Appeals will deprive farmers in many states of the Union of a tax deduction for an item which is, from any realistic standpoint, an essential item of annual expense in their farming operations. Here the Court of Appeals has acquiesced in the Government's highly theoretical approach to something that was intended by the Congress to be—ought surely remain—a very practical

matter. In so doing the Court of Appeals has departed from the principles of common sense which this Court has held to be determinative on the question whether a disbursement meets the statutory test of being an ordinary and necessary business expense. In so doing the Court of Appeals has likewise overturned and disregarded findings of the District Court which are amply supported by the record; such action by the Court of Appeals constitutes a flagrant departure from the principles of limited appellate review which are established both by Rule 52(a) of the Federal Rules of Civil Procedure and by a long line of decisions in this Court.

The importance of the questions presented appears from the record in this case and from other sources of information which are readily available.

The District Judge who heard this case and who presides in an area where irrigation problems are well known commenced his opinion with the following statement (R. 97):

> "This is a case which possibly can have very extensive effects in the 17 Western States that are dependent upon the use of water for the irrigation of crops in order for there to be a productive agriculture. It is impossible for me to see the case in any other light. At the same time I can understand how a lawyer, gazing at the asphalt on Pennsylvania Avenue in Washington, D. C. and concerned only with the printed word of the Federal Tax Laws and the decisions based thereon, in forming the policies of the Internal Revenue Bureau might possibly have a different concept of the situation."

And public records bear out what the District Judge stated as a matter of his own knowledge. In 1950, according to the Census of Agriculture (p. 58), there were 2886

incorporated mutual irrigation or ditch companies supplying water to many thousands of farmers and irrigating 5,639,447 acres.[2] About half of these mutual irrigation or ditch companies are concentrated in the states of Wyoming, Utah, Colorado, Kansas, New Mexico and Oklahoma—which are the states comprising the Tenth Circuit.

The importance of irrigation to agriculture is self-evident. In "Water", the Yearbook of Agriculture for 1955 (U. S. Department of Agriculture), it is stated that 27.5 million acres were irrigated in 1953. The report goes on to say (p. 247):

> "That is only 3.5 per cent of the total land in farms in those states, but its significance to agriculture is much greater than the figures indicates. About 12 per cent of all cropland harvested was irrigated .... The value of crops harvested from irrigated land was 35 per cent of the value of all crops harvested."

Irrigation, it can be seen, is a factor of major importance in our farm economy; and the second largest group of enterprises in the irrigation field are the incorporated mutuals which furnish water to more than 20% of all irrigated lands in the United States. These figures are meaningful since they help to establish the extensive hardship which the Court of Appeals decision will impose upon the farming industry unless the decision is promptly reversed.

Indeed, the vital role played by the mutual ditch or irrigation companies not only is well known, but has been

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[2] The Census of Agriculture does not state the number of farms so supplied with water, but "Irrigation Enterprise Organizations", U. S. Department of Agriculture Circular No. 934, (October, 1953, p. 21), states that the average acreage per farm served by mutuals was 88. This would indicate that more than 60,000 farmers receive their irrigation waters from mutual enterprises.

fully recognized in the opinion of this Court in *Farmers Reservoir & Irrigation Company* v. *McComb*, 337 U. S. 755 (1949). These mutual companies are not like the ordinary corporation. They have grown up and developed methods of operation over a period of years in the many states of the country in which water for irrigation is essential to farming. Although private organizations, the companies are organized as non-profit, tax-exempt corporations and they exist only for the purpose of providing water at cost to their farmer-members.[3] Stock of the two companies here involved is not like ordinary corporate stock. There is no speculation or regular market for such stock and no dividends are paid (R. 35, 99, 107). The only persons interested in owning such stock are farmers through whose lands the irrigation ditches run. Similarly, as the record here shows and as the findings of the District Court establish, petitioners' sole purpose in paying the annual assessments is to assure that the water will continue to be supplied to them (R. 34, 36, 63, 109).

The two mutual ditch companies to which petitioners paid the annual assessments in this case, and many of their counterparts scattered throughout the United States, are small companies and keep records in a simple, informal manner (R. 119). It was not the practice of these companies or of many others to establish reserves for depreciation or replacements—even though reservoirs silted up, ditches frequently required rebuilding, and repairs were not always made promptly (R. 70, 83, 86, 87, 107). Because of this, when maintenance could no longer be deferred, it was sometimes necessary for the companies to borrow money in order to keep the ditches and reservoirs in operation (R. 85, 107, 108). Sometimes when such debt was refinanced, back interest was added to the principal

[3] "Irrigation Enterprise Organizations"—U. S. Department of Agriculture Circular No. 934, pp. 19, 20.

of the debt (R. 71). At other times an emergency would arise because of a break in a ditch or collapse of a structure. On some of such occasions money would be borrowed, but here again, the indebtedness was incurred for repairs (R. 71). Similarly, the acquisition of a new right of way was not for the purpose of extending the activities of the company but merely intended to replace another right of way which could no longer be used (R. 113).

In other words, no matter in what form the money was spent by the mutual ditch companies, it was paid out only to keep the companies' properties in working operation and not to expand or extend them. The ditches, reservoirs and other structures were not added to. They were only repaired when damaged, or replaced when they no longer could be used. Consequently, even from the standpoint of the mutual ditch companies, the annual assessments which the farmer members were required to pay, in order to obtain current deliveries of water, were in fact used only for maintenance and operation and did not result in additions to capital. After all expenditures had been made, the companies had only what existed before (R. 107, 108, 112, 113), and the value of the shares owned by petitioners was not enhanced (R. 23, 24); indeed, the District Court specifically found that the expenditures made by the companies did not create capital (R. 24).

The above is the picture with respect to these two companies, as indeed it would be with respect to other mutual irrigation companies (R. 107, 108, 112, 113, 119). So far as the farmers are concerned it is even simpler. The farmers have only one purpose—to obtain water necessary for irrigation. The payment of the full amount of the annual assessments is an ordinary and necessary expense if they are to be able to operate their farms. Petitioners paid the assessments when levied, since otherwise their water would have been cut off. What petitioners were doing

was to buy water, in the manner customary for the farmers in the area where petitioners carry on their farming operations (R. 36, 48). Their situation is typical of the situation of many thousands of other farmers who must do the same.

What happens in this case, therefore, is not only of importance to the three farmers now petitioning this Court, but to many thousands of farmers who depend upon mutual companies to supply the water needed for their farms. By every test which this Court has prescribed, the full amounts of such annual assessments are ordinary and necessary business expenses to the farmer. This they are if the language of the Internal Revenue Code is "to be read in its natural and common meaning", *Welch* v. *Helvering*, 290 U.S. 111, 114 (1933); or if the word ordinary is to be given "the connotation of normal, usual, or customary", *Deputy* v. *DuPont*, 308 U.S. 488, 495 (1940); or if the words ordinary and necessary "be given their commonly accepted meaning", *Commissioner* v. *Heininger*, 320 U.S. 467, 471 (1943); or if the deduction is to be measured by "the fair and natural meaning" of the Code, cf. *Lykes* v. *United States*, 343 U.S. 118, 120 (1952). The criteria established by these decisions leave no room for the result reached here by the Court of Appeals.[4]

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[4] An additional ground for rejecting the result reached by the Court of Appeals can be found in other types of cases relating to deductions for ordinary and necessary business expenses, where the lower courts have looked behind the labels placed on expenditures in order to arrive at determinations which are in accord with the substance of the entire transaction. This has been particularly so where expenditures, although bearing some semblance in form to capital contributions, in substance were ordinary and necessary expenses made by the taxpayer for the purpose of permitting him to continue to operate his business. *Commissioner* v. *The Hub*, 68 F. 2d 349 (4th Cir., 1934); *Commissioner* v. *Bagley & Sewall Company*, 221 F. 2d 944 (2d Cir., 1955). See also *Teleservice Company of Wyoming Valley*, 27 T.C. 722 (1957), on appeal to Third Circuit; *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955); *Western Wine & Liquor Co.*, 18 T.C. 1090 (1952).

In reaching such an unjust result in this case, it was necessary for the Court of Appeals to override the specific and the general findings which the District Court had made upon a full record (see pages 5-7, above). For example, the District Court found, on the evidence, that it was petitioners' intention, in paying the assessments, to assure delivery of water and "not to make a contribution to the capital" of the mutual ditch companies. Yet the Court of Appeals took it upon itself to reverse on the ground that "the intended purpose" of petitioners "was to strengthen the financial position." Upon the detailed circumstances shown by the record, the District Court found that the full amount of the assessments paid by petitioners were ordinary and necessary business expenses; yet the Court of Appeals held the contrary with respect to the allocated portions actually in issue in the litigation.

What the Court of Appeals has done in overturning these findings not only works to the great detriment of the farming community of this Nation, but it is also in direct conflict with Rule 52(a) of the Federal Rules of Civil Procedure and with applicable decisions of this Court. Rule 52(a) provides, with respect to all actions tried upon the facts without a jury, that "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses". Moreover, this Court specifically held in *Commissioner* v. *Heininger*, 320 U.S. 467, 475 (1943), that "Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances". This principle is firmly accepted in most circuits.[5] The

[5] *Revere Racing Association* v. *Scanlon*, 232 F. 2d 816, 818 (1st Cir. 1956); *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944, 946 (2nd Cir., 1955); *Chester Distributing Co.* v. *Commissioner*, 184 F. 2d 514, 515 (3rd Cir. 1950); *Nowland* v. *Commissioner*, 244 F. 2d 450, 454 (4th Cir.,

present decision establishes that the Court of Appeals for the Tenth Circuit now constitutes a notable exception. The Tenth Circuit's plain disregard of this well-settled principle calls for the exercise of this Court's supervisory jurisdiction.

CONCLUSION

This Court has emphasized that "Taxation is an intensely practical matter and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences." *Farmers Loan & Trust Co.* v. *State of Minnesota*, 280 U.S. 204, 212 (1929). Farming and the expenses payable in connection therewith are also practical matters, and the taxes payable by farmers should be levied accordingly. As this Court has said in connection with other legislation affecting farmers, the courts have a duty to see that the benefits of legislation are not "frittered away by narrow formalistic interpretations which disregard the spirit and the letter of the Act". *Wright* v. *Union Central Life Ins. Co.*, 311 U.S. 273, 279 (1941); *Wright* v. *Logan*, 315 U.S. 139, 141-142 (1942).

The practical situation—as the District Court which tried the facts in this case found—was that annual assessments were paid to obtain water and that this was an ordinary and necessary expense of conducting the business of farming. Since "it is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs," *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451, 456 (1950), the appellate courts should accept the determination so

1957); *Limerick, Inc.* v. *Commissioner*, 165 F. 2d 483, 484 (5th Cir., 1948); *United States* v. *E. L. Bruce Co.*, 180 F. 2d 846, 847 (6th Cir. 1950); *Clinton Co.* v. *Commissioner*, 159 F. 2d 102, 104 (7th Cir., 1946); *Byers* v. *Commissioner*, 199 F. 2d 273, 276 (8th Cir., 1952); *United States* v. *Star-Kist Foods*, 240 F. 2d 759, 762 (9th Cir., 1956).

made. The farming community of the Nation should be promptly relieved of the unjust burden imposed on it by the decision of the Court of Appeals.

For the foregoing reasons the petition for certiorari should be granted.

Respectfully submitted,

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January, 1958

APPENDIX

OPINION OF DISTRICT COURT, AFTER TRIAL

The Court [Breitenstein, D.J.]: Well, I think I might as well decide this at this time. You are going to have to bear with me a little because I haven't had too much of an opportunity to consolidate my thoughts the last few weeks.

In this case the plaintiffs are suing for a refund of income tax paid to the United States. The situation arises from the fact that the plaintiffs are farmers who received their water from certain mutual ditch companies. The two companies involved are Water Supply and Storage Company and the North Poudre Irrigation Company. These are corporations not for profit, organized under Colorado law. They distribute water to the farmers who use the water for the growing of agricultural crops. In the years in question the annual assessments made by each company included items which the Government contends amount to contributions to capital assets and are in excess of the amount reasonably and properly required for repairs and maintenance and operation, and as to such portions of the assessments that are in excess of the requirements for maintenance and operation the Government contends that the farmer is not entitled to deduct such amounts as ordinary and necessary expenses paid or incurred during the taxable years in question.

This is a case which possibly can have very extensive effects in the 17 Western States that are dependent upon the use of water for the irrigation of crops in order for there to be a productive agriculture. It is impossible for me to see the case in any other light. At the same time I can understand how a lawyer, gazing at the asphalt on Pennsylvania Avenue in Washington, D. C. and concerned only with the printed word of the Federal Tax Laws and the decisions based thereon, in forming the policies of the Internal Revenue Bureau might possibly have a different concept of the situation.

The use of these mutual ditch companies is not confined to the State of Colorado. It is common in the Western

States. The Supreme Court of Colorado in the case of Coffin v. The Left Hand Ditch Company, 6 Colorado, page 443, had some discussion of the situation which confronted the Colorado settlers. It said this:

"The climate is dry, and the soil, when moistened only by the usual rainfall, is arid and unproductive; except in a few favored sections, artificial irrigation for agriculture is an absolute necessity. Water in the various streams thus acquires a value unknown in moister climates. Instead of being a mere incident to the soil, it rises, when appropriated, to the dignity of a distinct usufructuary estate, or right of property. It has always been the policy of the national, as well as the territorial and state governments, to encourage the diversion and use of water in this country for agriculture; and vast expenditures of time and money have been made in reclaiming and fertilizing by irrigation portions of our unproductive territory. Houses have been built, and permanent improvements made; the soil has been cultivated, and thousands of acres have been rendered immensely valuable, with the understanding that appropriations of water would be protected. Deny the doctrine of priority or superiority of right by priority of appropriation, and a great part of the value of all this property is at once destroyed."

The Court goes on to say, on the same page:

"* * * we think it is, and has always been, the duty of the national and state governments to protect (this right). The right itself, and the obligation to protect it, existed prior to legislation on the subject of irrigation."

And I might add parenthetically it existed prior to legislation on the subject of income tax liability.

The Supreme Court of the United States has recognized the same thing. Among other cases wherein it has been recognized is the decision in Clark v. Nash, 198 U.S. 361. There in talking about the difference between the East and the West the Court says, on page 370:

"The rights of a riparian owner in and to the use of the water flowing by his land are not the same in the arid and

mountainous States of the West that they are in the States of the East. These rights have been altered by many of the Western States, by their constitutions and laws, because of the totally different circumstances in which their inhabitants are placed, from those that exist in the States of the East, and such alterations have been made for the very purpose of thereby contributing to the growth and prosperity of those States arising from mining and the cultivation of an otherwise valueless soil, by means of irrigation. This court must recognize the difference of climate and soil, which render necessary these different laws in the States so situated."

Now, I recognize those are general statements. To me they have some pertinence here.

The first Colorado Supreme Court case that discusses the status of these companies seems to be Kendrick v. Twin Lakes Reservior Company, 58 Colorado 281. Prior to that case there were innumerable decisions that need not be mentioned, which pointed out consistently, time after time, that in a ditch company or a reservoir company the water rights are not owned by the company but are owned by those who put the water to beneficial use. That is elementary Hornbook law in Colorado. In the Kendrick case, which involved a mutual reservoir Company, the Court on page 282 says:

"The corporation is purely a mutual reservoir company, in which the capital stock stands for and represents the consumer's interest in the reservoir, canal and water rights. The benefit derived from owning the stock, is the exclusive use of the water it represents. It is not a dividend corporation, a dividend has never been declared, and under its charter, never can be declared on its capital stock."

That decision was in 1914. As I recall, that is the year after the income tax amendment to the Federal Constitution was adopted. The Court said then that one of these companies was not a dividend corporation.

There are a number of other cases. One which is of some interest because it was decided by my colleague, Judge William Lee Knous, when he was on the Supreme Court of Colorado, is Beaty v. Commissioners, 101 Colorado 346. Reading from page 351, this is the same quotation Mr. Swanson read this morning, Judge Knous said this:

"It definitely appears that this mutual canal company was organized for the convenience of its members in the distribution to them of their water for use upon their lands in proportion to their respective interests. Under these circumstances the stock certificates of the canal company, in the form in which they were issued and held by the plaintiff, were merely the muniments of title to her water right, which water right, the thing of value owned by her, unquestionably was real estate and not corporate stock."

Judge Knous refers to some other decisions where the same holding is made.

The last case that I know of is also one which Mr. Swanson mentioned this morning, Billings v. Industrial Commission, which involved a question of whether or not an injury received by an employee of a mutual ditch company was compensable. The Court in discussing the character of these companies says this:

"Under the undisputed facts of this case the conclusion is inescapable that the Billings Ditch is a mutual irrigation ditch, and that the corporation is merely the vehicle by which its owners operate and manage its affairs. It was neither organized, nor is it operated, for profit, but solely for the convenience of its members in the management of their irrigation system and the distribution of the proper apportionment of water to the owners as their respective interests may appear; the shares of stock being merely incidential to the ownership of the water rights." Then it cites a number of cases.

"The shares of stock," says the Court, "in the Billings Ditch Company are not personal property, but represent

varying interests in separate parcels of real estate. The opinion cites some more cases and goes on:

"What it does, and the practice and policy adopted by a corporation in its operation, rather than the language contained in its articles of incorporation, are determinative of its character."

So we have here a couple of mutual ditch companies, corporations not for profit, that serve as the facilities through which the farmers get the water which they have to have to irrigate their lands to raise crops. Now, it is true that these companies have constructed works, reservoirs, canal systems, diversion works and things like that. But as said in the 58 Colorado case, those are of value only as they permit the diversion and use of water through them, and separate and apart from that they have no value. It is a matter of common knowledge that here on the Eastern Slope of Colorado the streams have been over-appropriated for many, many years. In fact, in recent years 1870 rights on the South Platte yielded very little water. That being true, it seems to me that it is apparent, I think the evidence in this case justifies the conclusion, that these expenditures which are made by these companies are merely to continue the assured availability and continued availability of the water divertible under the rights which are owned and used by the shareholders in the company. They do not create capital in the true sense of the word. The value is in the water rights and the rights to divert the water are old, old rights. The expenditure of this new money does not add one iota to the yield of any of those water rights, doesn't get any more water from them. All it does is to facilitate, expedite or assist, whatever you want to call it, in the diversion and distribution of the water which is covered by these old rights.

So you have a situation where the Government, in effect, claims that part of the charge which the farmer pays is not a proper business expense because it goes to a capital item, the retirement of bonded debt, the purchase of a dragline, the purchase of a truck, the building of a new diversion structure, or the purchase of a right of way that may be necessary in order to add to the usefulness of a

ditch. None of those things have any real value separate and apart from the water because if it wasn't for the water they would not be needed. They only assist in getting the water from the streams, the lakes, to the soil where it grows crops.

The testimony is clear that the assessments made against these farmers by the two companies had to be paid or the farmers wouldn't get any water. They couldn't pay part of the assessment and demand the right to water. They had to pay the whole assessment in order to get their water. If they didn't pay it the water was shut off and their stock would be sold to somebody who was willing to pay for it. We are not concerned here with a case of the taxability of a capital gain on the sale of a farm. We are not concerned with the taxability of income to one of these companies. We are not concerned with a possible tax on the proceeds from a liquidation of a company and distribution of its assets among those entitled thereto. We are just concerned with the question of whether or not a farmer is entitled to deduct as an ordinary and necessary business expense the sum of money he had to pay in order to get water for the ensuing year.

The Supreme Court of the United States and the Supreme Court of Colorado has recognized the absolute necessity of the use of water in semi-arid regions, such as we have here, for irrigation. The Supreme Court of Colorado has recognized the status of these companies as being that of facilities which are organized to get the water to the farmers. The Supreme Court of Colorado has said that the stock certificates represent only the right of the farmer to receive water, that they are not personal property but real property.

Under all the circumstances, it seems to me that these assessments which have to be paid in order for the farmer to receive the water to grow his crops are ordinary and necessary expenses paid or incurred during the taxable year in carrying out the trade or business of farming. That being so, under the applicable section of the income tax laws they are deductible. Accordingly, judgment will be entered in favor of the taxpayers and against the Government.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND JUDGMENT OF DISTRICT COURT

This matter coming on to be heard on the 22nd day of June, 1956, the plaintiffs being represented by Stanley L. Drexler, Esq., and Ellis J. Sobol, Esq., and the defendant being represented by Robert Swanson, Esq., Assistant U. S. Attorney for the District of Colorado, and the Court having considered the testimony of the witnesses, read the pleadings, examined the evidence introduced, having heard the statements of counsel and being fully advised in the premises, the Court doth find as follows:

1. The facts stipulated by the parties are so found.

2. This is an action for refund of income taxes paid by plaintiffs to the United States.

3. The plaintiffs, Victor H. and Elsie Akin, Fred C. and Alice M. Kluver and E. F. and Gladys Munroe were husband and wife during all times relevant herein.

4. The plaintiffs each filed timely joint individual federal income tax returns for the taxable years ended December 31, 1949, and December 31, 1950, with the Collector of Internal Revenue for the District of Colorado and paid to the said Collector the taxes shown to be due thereon.

5. During the said taxable years the plaintiffs each were engaged in the business of farming.

6. During the said taxable years, Victor H. Akin and Elsie Akin, Fred C. and Alice M. Kluver and E. F. Munroe were stockholders in and obtained water for irrigation of their farms from the North Poudre Irrigation Company. During said taxable years Victor H. Akin, Fred C. and Alice M. Kluver were stockholders in and obtained water for irrigation of their farms from The Water Supply and Storage Company.

7. The North Poudre Irrigation Company and The Water Supply and Storage Company are both corporations not for profit, organized under Colorado law. They distribute water to farmers who use the water for the growing of agricultural crops.

8. During each of the years involved each of the companies levied annual assessments on their stockholders.

The plaintiffs herein paid the assessments so levied and deducted the amounts paid on their federal income tax returns as ordinary and necessary business expenses of farming.

9. The Commissioner of Internal Revenue disallowed that portion of the assessments so paid and deducted which was allocated or spent by the companies for expenditures of a capital nature and debt retirement and assessed deficiencies in income tax against the plaintiffs.

10. The plaintiffs paid the assessed deficiencies on November 4, 1952, to the Collector of Internal Revenue for the District of Colorado, the following amounts paid being attributable to the disallowance of the deduction of a portion of the assessments paid:

	1949	Assessed Interest	1950	Assessed Interest
Akins	$ 606.72	$ 96.13	$.....	$.....
Kluvers	1,135.90	164.25	1,135.90	154.56
Munroes	182.14	2.93	237.38	23.97

11. For the taxable year 1950 the Commissioner of Internal Revenue allowed the Akins a refund in the amount of $613.72 arising out of adjustments not here involved and conceded by defendant to be correct, instead of the amount of $1,190.63, by which the Akins alleged they overpaid their tax for the year. The amount overpaid attributable to the aforesaid disallowance of deduction of a portion of the assessment paid to the said companies is $576.91.

12. On May 12, 1953, the plaintiffs filed with the Director of Internal Revenue for the District of Colorado claims for refund for each of the said amounts for each of the years as set forth above.

13. More than six months elapsed from the time plaintiffs filed their claims for refund until the time of filing of this suit.

14. The plaintiffs used substantially all the water obtained from the companies in their business of farming. (In one year involved, Mr. Kluver rented a small amount of water to a neighbor as an accommodation.)

15. The assessments made by the companies had to be paid in order for the plaintiffs to obtain water. If the

assessments had not been paid, plaintiffs' water would have been shut off and their stock could have been sold. In paying the assessments, the plaintiff's intention in each case was to assure the delivery of water, if available, and not to make a contribution to the capital of the corporations.

16. The expenditures by the companies out of the monies obtained from the assessments were made merely to assure the continued availability of water divertible under the water rights held by the companies in trust for the stockholders.

17. The value of the stock of the companies here involved is in the water rights and the expenditure of new money does not add to the yield of the water rights.

18. It is common knowledge that on the Eastern Slope of Colorado the streams have been over-appropriated for many, many years and that there has not been enough water to satisfy agricultural needs.

Conclusions of Law

The Court has jurisdiction of the parties and of the subject matter of this action

19. Under Colorado law, a water right, i.e., the right to divert water from a natural stream and put it to beneficial use, is owned by he who actually puts the water to beneficial use and is not owned by the ditch or reservoir companies which are devices for getting the water to the users.

20. Under Colorado law, a water right is a distinct usufructuary estate, or a right in property.

21. Under Colorado law, non-user of a water right results in an abandonment of such right.

22. Under Colorado law, the stock certificates of a mutual ditch, irrigation or reservoir company such as the companies here involved represent only the right to receive water and they are not personal property but real property.

23. The expenditures made by the companies here involved did not create capital within the meaning of the 1939 Internal Revenue Code.

24. Amounts paid by plaintiffs, farmers, pursuant to stock assessments by Colorado mutual ditch and irrigation companies, not for profit, the payment of such assessments to the companies being a condition precedent to the right to receive water for irrigation of their farms, and the water so obtained being used for the irrigation of their farms, constituted ordinary and necessary expenses paid or incurred during the taxable year in carrying on their farming business within Sec. 23(a) (1) 1939 Internal Revenue Code and hence were deductible in full from gross income.

25. The income taxes and interest here involved were illegally and erroneously collected by the United States.

Accordingly, it is adjudged and decreed that the plaintiffs are entitled to receive refunds of taxes and interest and that the defendant shall pay such refunds in the following amounts:

1949

	Tax Overpayment	Interest Overpayment	Total Refund
Akins	$ 606.72	$ 96.13	$ 702.85
Kluvers	1,135.90	164.25	1,300.15
Munroes	182.14	2.93	185.07

1950

	Tax Overpayment	Interest Overpayment	Total Refund
Akins	$ 576.92	$	$ 576.92
Kluvers	1,619.26	154.56	1,773.82
Munroes	237.38	23.37	260.75

	1949 and 1950 Total Refund
Akins	$1,279.77
Kluvers	3,073.97
Munroes	445.82

Plus interest in each case as provided by law.

Done this 22nd day of June, 1956, in open court.

JEAN S. BREITENSTEIN,
Judge,
United States District Court,
for the District of Colorado.

Entered on the docket, June 22, 1956, G. Walter Bowman, Clerk.

OPINION OF THE COURT OF APPEALS
(October 19, 1957)

Before BRATTON, Chief Judge, and HUXMAN and MURRAH, Circuit Judges.

BRATTON, Chief Judge.

The question presented for determination is whether portions of annual assessments paid by taxpayers who were farmers to two mutual ditch companies which supplied water for the irrigating of the farms of the taxpayers and were used by such companies to retire long term indebtedness and to purchase a right of way were deductible from gross income of the taxpayers as ordinary and necessary expenses incurred in carrying on their farming businesses.

The taxpayers were engaged in the business of farming in Colorado, and they obtained water for the irrigating of their farm lands from two mutual ditch companies. The ditch companies were corporations organized under the laws of Colorado, and they distributed water to farmers who used it for the growing of agricultural crops. In order for a water right owner to be entitled to receive water distributed by the companies, it was necessary that he have stock in the company with all assessments paid. If a stockholder defaulted in the payment of an assessment, interest was charged; and if he remained in default after notice and demand for payment, his stock could be sold at public auction. During the years 1949 and 1950, each company made an assessment pro rata upon all of its stock issued and outstanding. Each assessment of one company contained an item for the retirement pro tanto of a long term indebtedness, an item for the payment of interest on the outstanding indebtedness, and an item for the purchase of a right of way; and each assessment of the other company contained an item for the retirement in part of a long term indebtedness, and an item for the payment of interest on such indebtedness. The taxpayers paid the respective annual assessments levied upon them by one or both of the companies and deducted the amounts thereof from their

gross income as ordinary and necessary business expenses incurred in the operation of their farming businesses. The Commissioner of Internal Revenue disallowed the portions of the deductions attributable to the items referred to. Resulting deficiencies in tax were paid; claims for refund were made and disallowed; this suit was filed to recover the amounts of the deficiencies; judgment was rendered for the taxpayers; and the appeal was seasonably taken from the judgment.

Deductions from gross income are not a matter of right. Neither do they turn upon equitable considerations. They are a matter of legislative grace. And a taxpayer asserting a deduction, must bring himself squarely within the terms of a statute expressly authorizing it. New Colonial Ice Co. v. Helvering, 292 U.S. 435; White v. United States, 305 U.S. 281; Deputy v. DuPont, 308 U.S. 488; Hales-Mullaly, Inc. v. Commissioner, 131 F. 2d 509; F. A. Gillespie & Sons Co. v. Commissioner, 154 F. 2d 913, certiorari denied 329 U.S. 781; Chicago Mines Company v. Commissioner, 164 F. 2d 785, certiorari denied 333 U.S. 881.

Section 23(a)(1)(A) of the Internal Revenue Code of 1939 authorizes a deduction from gross income of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. But the statute is limited to ordinary and necessary expenses paid or incurred in the conduct of a trade or business and does not authorize a deduction for capital expenditures. Welch v. Helvering, 290 U. S. 111; Hales-Mullaly v. Commissioner, supra. It is not always easy to find a verbal formula which readily supplies an unerring guide in drawing the boundary line between current expenses and capital outlays. But it may be said in general terms that an expenditure should be treated as one in the nature of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year. Hotel Kingkade v. Commissioner, 180 F. 2d 310.

The parties discuss the relationship existing between the ditch companies and the taxpayers as throwing light

upon the decisive question whether the sums which the taxpayers paid to the ditch companies for use in retiring in part the outstanding indebtedness of the ditch companies, and for use in acquiring the right of way, constituted ordinary and necessary expenses incurred by the taxpayers in the conducting of their farming businesses. The status of property in respect to the rights and interests of parties therein is created and determined by state law, but the manner in which and the extent to which parties are liable for federal taxes must be determined by federal revenue legislation. Morgan v. Commissioner, 309 U.S. 78; Helvering v. Stuart, 317 U.S. 154; Broderick v. Gore, 224 F. 2d 822; Broderick v. Moore, 226 F. 2d 105; Smith v. United States, 230 F. 2d 470; In re Sweet's Estate, 234 F. 2d 401, certiorari denied, 352 U.S. 878.

As we understand the law of Colorado, the two mutual ditch companies organized in that state are nonprofit corporations; each owns the naked legal title to its ditches and related facilities used in the distribution of water to its members, including the taxpayers, for use upon their lands but the owners of the farms served in that manner are the equitable and actual owners of such ditches and related facilities in proportion to their respective interests; the stock certificates issued by the companies to their members are merely muniments of title to their water rights; and the value of the stock is in the water rights which it represents. Kendrick v. Twin Lakes Reservoir Co., 58 Colo. 281, 144 Pac. 884; Beaty v. Board of County Commissioners of Otero County, 101 Colo. 346, 73 Pac. 2d 982; Billings Ditch Co. v. Industrial Commission, 127 Colo. 69, 253 Pac. 2d 1058. But in each instance here, the ditch company was the only one liable upon the outstanding indebtedness for the retirement of which a portion of the amounts paid by the taxpayers to the ditch company was to be used. The taxpayers were not personally liable for any portion of the indebtedness. And the intended purpose and resulting effect of the payments made by the taxpayers to the ditch companies for use in the retirement pro tanto of the principal together with the accrued interest thereon was to strengthen the financial position of the ditch companies by reducing their

long-term obligations. In respect to federal revenue legislation, the payments of assessments for such purpose fell within the range of capital contributions to the ditch companies, respectively, rather than ordinary and necessary expenses incurred in carrying on the businesses of the taxpayers. Compare, 50 East 75th Street Corp. v. Commissioner, 78 F. 2d 158. The legal title to the right of way acquired with the proceeds of the assessments for that purpose was taken in the name of the ditch company. And the purpose in acquiring and taking legal title to the right of way was to expand the distribution system by creating an addition to it. Again, the payments of the assessments for that purpose constituted capital contributions, not ordinary and necessary expenses incurred by the taxpayers in carrying on their businesses. Compare, Cripple Creek Coal Co. v. Commissioner, 63 F. 2d 829.

The judgment is reversed and the cause is remanded.

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